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WHEN MAY A RAILROAD COMPANY MAKE GUARANTIES?

The question of a railroad company's power to make guaranties usually arises upon collateral undertakings of this character, written upon the bonds and coupons of another company, in whose success the guarantor has an interest. The underlying principles which control the power are common in theory to private corporations in general. But the volume of railroad securities is now so great, and their sale so large an element in the activities of investment, that our discussion need not go beyond this class of corporations.

The transportation companies are closely allied in business—the overwhelming tendency of the day is to consolidate lines by merger, or lease, or traffic contract. A receiver of an extensive railroad system in the West informed the writer of this article last Summer that although he had the care of more than a thousand miles of road, reaching into eight or ten large cities the principal corporation in his care had no interest of ownership in a terminal station at any one of the large cities. They were all controlled by lease or traffic contract. The property under his care was originally owned by ten or more corporations. This single example, which has exceptional features in the matter of terminals, is not, on the whole altogether strange in the history of modern railroad companies. As railroads have been largely built upon bonds, and as the bonds are constantly maturing, and are usually renewed in some form or another, it is to be expected that new parties will be interested in their renewal, and so it is every day's experience, that the investing public is asked to purchase bonds of a railroad company which are guaranteed for principal and interest by another corporation.

Two suggestions are worthy of early consideration in examining the subject: First, the contract of guaranty of negotiable securities, unless restricted in its terms, is held to be a contract by the guarantor with the owners of the guaranty. Second, the general power of guarantying the contracts of one company by another is held to a less strict limitation in the case of bonds and coupons than of some other contracts. The reason for this

distinction in favor of negotiable bonds and coupons is, that railroad bonds, payable to bearer, are held both in this country and England to pass, like bills and notes, free from equities existing between the original holders. Authorities to this point the student will find collected at considerable length in *Jones on R. R. Securities*, Secs. 197 and 198.

The language of Judge Nelson, in *White v. R. R. Co.*, 21 How. 575, expresses in forcible phraseology, the common result of intelligent tribunals in this matter. The Supreme Court of Indiana in *R. R. Co. v. Cleneay*, 13 Ind. 161, says: "Though not exactly governed by the law merchant, these bonds are entitled to the privileges of commercial paper." The negotiability of coupons payable to bearer is even more pronounced than of the bonds themselves. They are held to possess all the attributes of negotiable paper. The purchaser acquires title by delivery, and the promise to bearer is a promise to him directly. The title passes from hand to hand by mere delivery, and the transfer of possession is presumably the transfer of title.¹

Upon general principles of law a railroad company has no power to guaranty the contracts of another company, unless such power is expressly conferred by law, or is incidental to its corporate character. A leading case in England on this subject is *Coleman v. R. R. Co.*, 10 Beav. 1. In that case the railroad company thought it could increase its traffic and profits by the aid of a steam packet company to be formed and whose vessels should run from its railroad terminus to the northern parts of Europe, and they attempted to guaranty five per cent dividends to the stockholders of the packet company. A shareholder in the railroad company sought an injunction, and Lord Langdale, Master of the Rolls, held that no such contract was within the power of the railroad company. His opinion as to the importance of preserving the property of railroad companies may seem strange to some readers to-day: "If there is one thing more desirable than another, after providing for the safety of all persons traveling on railroads, it is this, that the property of a railroad company shall be itself safe; that a railroad investment shall not be considered a wild speculation exposing those engaged in it to all sorts of risk, whether they intended it or not. Considering the vast property which is now invested in railroad companies, and how easily it is transferable, perhaps one of the best things that could happen would be that the

¹ See *Mercer County v. Hackett*, 1st Wal. 83. *Ketchum v. Duncan*, 96 U. S. 659. *Haven v. R. R. Co.*, 109 Mass. 88.

investment should be of such a safe nature that prudent persons might, without improper hazards, invest their moneys in it. Quite sure I am that nothing of that kind can be approached, if railroad companies shall be at liberty to pledge their funds in support of speculations not authorized by their legal powers, and might possibly, to say the least, lead to extraordinary losses on the part of the company." This case has been approved by the United States Supreme Court in *Pearce v. R. R. Co.*, 21 How. 441, and in *Pa. Co. v. R. R. Co.*, 118 U. S. 290. The case of *Madison Plank Road Co. v. Watertown Co.*, 7 Wis. 59, held that the railroad company's guaranty of a loan to the Plank Road Company, which was in continuation of the railroad company line, was in excess of the powers of the railroad company. This case has also been favorably quoted by the Supreme Court of the United States.²

That the legislative power may be expressed in a private charter or by general law is conceded by all the cases.

The General Statutes of Connecticut restrict the issue of guarantees by railroad companies and of course, by implication, thereby recognize the right as one to be exercised under proper circumstances and within the statutory limits.

The rule of presumption of legality or illegality has been several times adjudicated. The leading case is *R. R. Co. v. Howard*, 7th Wal. 392. The opinion says: "Private corporations may borrow money or become parties to negotiable paper in the transaction of their legitimate business, unless expressly prohibited; and, unless the contrary is shown, the legal presumption is, that their acts in that behalf were done in the regular course of their authorized business."

The instances in which a railroad company has an implied power to make such guaranties are commonly found where the company has acted upon a consideration for its own benefit and under the general powers of making beneficial contracts within the lines of its corporate purposes, which is an incident to all corporate business. Thus a guaranty of this kind is held to be good where the guarantor owned all the capital stock of the principal debtor; where the debtor's road was an essential part of the general system of the guarantor, or was held by the guarantor under lease; where the guarantor had advanced the money in its own interest, and not against legislative prohibition, to build the road of the debtor company, and the bonds were used to reimburse them for the money advanced; where

²See also *Transp. Co. v. P. P. Co.*, 139 U. S. 478.

the bonds of the debtor company were owned by the guarantor, and were by it negotiated for the purpose of giving additional credit to the instrument, and where the consideration of the negotiation of guaranty was actually received by the guarantor and appropriated to its own use. Cases supporting these propositions are many. We give a few of the principal ones.³

Our Connecticut Courts define these incidental powers as those which are necessary to the use of a corporation's granted powers. Thus the power to make notes for debts, or to evidence the consideration of a mortgage of real estate properly purchased, are incidental; the one to the business methods of the day, and the other to the right of purchasing land. On the other hand, the same courts hold that making accommodation paper for another's benefit is *ultra vires*. The Connecticut courts include as within the chartered powers of a corporation those acts which may be exercised within the "fair intent and purposes of their creation."

The principle of estoppel has been by some eminent tribunals, held to defeat the defense of *ultra vires*, when made by a company against a *bona fide* holder of securities for value. In the case already cited in the 7th of Wallace the Court says: "Corporations as much as individuals are bound to good faith and fair dealing, and the rule is well settled that they cannot, by their acts, representations or silence, involve others in onerous engagements, and then turn around and disavow their acts, and defeat the just expectations which their own conduct has superinduced."

In the case of *Arnott v. R. R. Co.*, already cited, and approved by later cases in New York, the Court of Appeals held that, even if a guaranty were originally an act *ultra vires*, when it is transferred for a valuable consideration the defense cannot be maintained.

The case of *Credit Co. v. Howe Machine Co.*, 54 Conn. 357, is an important one to our discussion. The defendant, a manufacturing company, was limited by its charter, in its use of mercantile paper, to the convenient prosecution of its business. The Treasurer of the company, who was the proper officer to

³ *Zabriskie v. R. R. Co.*, 23 How. 381. *Todd v. Ken. U. Co.*, 57 Fed. Rep. 47. *Marbury v. Ken. U. Co.*, 62 Fed. Rep. 350. *Arnott v. Erie R. R. Co.*, 67 N. Y. 321. *Rogers Works v. Southern R. R. Assoc.*, 34 Fed. Rep. 278. *Low v. R. R. Co.*, 9 Am. R. R. 366. *Olcott v. R. R.*, 27 N. Y. 546. *Smith v. Johnson*, 3 H. & N. 222. *R. R. Co. v. Fletcher*, 24 A. & E. R. R. cases 24.

make acceptances, accepted accommodation drafts made for the benefit of a former president. The court estopped the defendant from setting up the claim of *ultra vires*. If railroad bonds and coupons are to have the same protection, in the hands of *bona fide* holders for value, as notes and bills, the doctrine of this case would prevent the companies from setting up the defense. In drawing a distinction between the notice that a party dealing with a corporation is bound to take of the extent of its corporate power, and of the circumstances under which the power is exercised, the opinion says that parties may be required to take notice of the former, but to require them to take notice of the latter would frequently result in gross injustice.

It has been claimed that the obligation of a guarantor is to be strictly confined to the precise terms of his guaranty, and this principle has been asserted in a number of strong cases. But it should not be forgotten that the converse of this proposition has been held by equally good authority—to wit, that a guaranty is to be construed as strongly against a guarantor as its terms will admit. The case of *Douglas v. Reynolds*, 7 Peters 113, has been recognized as a leading case upon the point, and followed by as many as eight cases in the Supreme Court of the United States.

In *Bank v. Savings Bank*, 21 Wal. 294, there was a written guaranty against shipment of cattle to the extent of \$10,000. It appeared upon the trial that the only cattle shipped were a lot of hogs, and the guarantor claimed strict privileges, and that the terms of the guaranty didn't apply to hogs. But the Court dismissed the defense, and said: "Like all other contracts it must receive the construction which is most proper and natural under the circumstances, so as to attain the object which the parties to it had in making it." And the same court in *Davis v. Wells*, 104 U. S. 159, uses significant language when it says that "the contract of guaranty is to be liberally construed to advance commercial intercourse."

Questions sometimes arise as to the nature of these guaranties. When the guaranty is attached to the bond and the bond makes reference to a mortgage which has peculiar provisions about foreclosure and limitations upon the maker's liability other than as owner of the property, the claim is set up that the guaranty is one of collectibility under the terms of the mortgage and not of payment. It may be fairly said that, if the word "payment" is used, a court will be reluctant to reduce the con-

tract from the well-known and important commercial contract of guaranty of payment to the inferior and uncommercial contract of collectibility. Because the bonds and especially the coupons are protected by the law merchant, there is justifiable inclination on the part of courts to hold guarantors, in actions by *bona fide* holders for value, to the responsibilities of the ordinary guaranty of payment.

In the case of *Security Co. v. Lombard Co.*, 73 Fed. Rep. 537, Judge Caldwell sustains the legal conclusion of the Master in Chancery, and fixes the obligation of a guaranty of payment as a direct and absolute thing upon default by the maker, but subordinates the right to enforce the guaranty to a period of two years after default, as specified in the guaranty.

There is a recent case (*Louisville Co. v. Ohio Valley Co.*, 69 Fed. Rep. 431) in which a number of the questions considered in this article are passed upon. The negotiability of the guaranty is sustained in face of a statute which made assignable obligations subject to equities. The guaranty in this case was set aside because not authorized by the stockholders. The directors authorized the execution of the guaranty, and the stockholders promptly disavowed the action of the directors. The court held that there was no recital in the bond or other circumstance in the case which estopped the stockholders from setting up the invalidity of the guaranty. The statute provided for railroad guaranties of the bond of other roads, and that they should be made, at the instance of the stockholders, by the board of directors. It was claimed in the argument that other statutes gave the corporation, by implication, authority to make these guaranties. The court held that the principal statute was exclusive in its effect, and that no other methods could be pursued by the corporation. Many authorities are cited to that point. The case is distinguished from the *Zabriskie* case, 23 Howard, already alluded to. It also approves Justice Swayne's language in *Merchants Bank v. State Bank*, 10 Wal. 604, as to estoppel, but points out the fact that the question of *ultra vires* did not and could not arise in the case.

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